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Efficient Debt Reduction

Jeffrey Sachs

Debt reduction poses collective action problems that cannot be efficiently handled in the framework of voluntary market-based approaches. Instead we need concerted debt restructuring, based on below-market interest rates — perhaps linked with credit enhancement by offical creditors — to provide the most direct mechanism for efficient, equitable sharing of losses.

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It is now widely acknowleged that under certain circumstances debt reduction can improve the welfare of both creditors and debtors. A large debt overhang can lead to inefficiencies that worsen the debtor's economic performance, thereby diminishing the creditor's expected returns. Leading banks and international financial institutions recognize this, but actual debt reduction has been remarkably limited. Bolivia remains the sovereign debtor that has been able to negotiate a fairly comprehensive debt reduction arrangement — and results have been favorable.

Why has there been so little progress in debt reduction?

Debt reduction poses important collective action problems that cannot be efficiently handled in the framework of "voluntary, market-based" approaches currently championed by the World Bank and the rest of the creditor community. Important distortions arise in the negotiating process because of the special position and incentives of the money-center banks and the recognized readiness of the official creditor community to contribute funds to avoid a breakdown of creditor-debtor relations.

Meaningful debt reduction requires an appropriate institutional setting to overcome collective action problems. In the domestic economy, bankruptcy law provides the framework for organizing the collective interests of the creditors when a debtor is distressed. No such institutional framework yet exists in the international setting. Under current incentives, voluntary debt relief is bound to mean no more than a continuing nibbling away at the edges of the debt overhang, without real relief for the debtor or real benefits for the creditors.

The author recommends "concerted debt restructuring," based on below-market interest rates, rather than "voluntary" debt reduction. With concerted relief, all banks would participate jointly on a fairly equal basis. The existing debt would be rescheduled at below-market interest rates, with the rates based on various indicators of ability to pay and decided in negotiations between the debtor country and creditor banks. The interest payments could be made more secure for the banks by various forms of credit enhancement, including collateralization, guarantees by the official creditor community, and escrow accounts in which export earnings are deposited for the purpose of future debt servicing. This approach would provide the most direct mechanism for an efficient, equitable sharing of losses among the creditor banks.

This kind of interest-rate reduction could be easily managed in the context of an international debt facility. Whatever the approach, meaningful debt reduction will require the active participation of the international community.

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by
Jeffrey Sachs

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Efficient Debt Reduction

1. Introduction

It is now widely recognized that the overhang of sovereign debt is imposing major costs not only on debtors but also on creditors, by seriously disrupting the debtor economies.[1] The World Bank, in the 1988-89 edition of the World Debt Tables has recently recognized that the debt overhang of the heavily indebted countries (the HICs) is "a burden . . . that reduces incentives to undertake sustainable long-term adjustment" (p.xvi) The costs of debt overhang have led to a widespread acceptance of the need for a process of debt reduction, by the World Bank and others. The major commercial banks have, in rhetoric at least, started to advocate debt reduction as one step out of the current crisis.[2]

In order to discuss the potential usefulness of debt reduction mechanisms, it is useful to have a working definition.

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[1]The economic crisis in Latin America, and the role of the foreign debt, is analyzed in Sachs (1988), which can be regarded as a companion paper to the current analysis.

[2]See for example, the recent statement of the Institute of International Finance, "The Way Forward for Middle-Income Countries", January 1989, which states that "the scope for voluntary debt reduction should be significantly enlarged" (p.2), and that creditor governments should seek ways to encourage banks to "accelerate the application of voluntary, market-oriented financing techniques that reduce existing bank debt"(p.4). Similar, Morgan Guaranty Trust, in the December 1988 issue of World Financial Markets states that the "multilateral organizations should support bank-debt reduction, for example, by helping debtors to issue new obligations of enhanced quality and retire existing ones at a discount" (p. 2).

I will define debt reduction as a restructuring of the outstanding debt in a way that reduces the expected present discounted value of the contractual obligations of the debtor. Thus, "debt reduction" will mean something more than simply lowering the amount of debt that is owed by repaying principal. It also means something more than converting the external debt into an internal debt that carries the same or greater debt servicing burden.[3] The overall terms of repayment must be eased in a present value sense.[4] Thus, debt reduction would include: a rescheduling of debt at sub-market interest rates; a cancellation of part of principal; exit bonds with sub-market interest rates; a buyback of debt at a discount relative to face value; etc.

Despite the discussion of debt reduction mechanisms in the

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[3]Some kinds of debt conversion give the creditor a local currency claim in place of the external claim. Typically, however, the local currency claim is indexed, and with a higher interest rate than on the external claim. I will not count that as a case of debt reduction, even though the measured cross-border debt is reduced.

[4]It is important to make this basic point since the banks have sometimes used the term "debt reduction" to mean little more than a reduction of the debt through a straightforward amortization of the debt, something that the banks obviously support, but which brings little comfort to the debtor country! Thus, in the recent debt rescheduling with Brazil, completed in September 1988, the banks advertised that the agreement led to a significant $4.5 billion reduction of debt in 1988. (See "Brazil Financing Plan, 1988-89", Citicorp, mimeo, September 1988). $3.4 billion of this "debt reduction", however, was simply the repayment by Brazil, at par, of arrears on earlier interest. Similarly, the banks advertised that Brazil would reap a $1.8 billion reduction in debt from a debt-equity program in which Brazil would buy the debt from the banks at <u>par value</u>. But since a repurchase at par is akin to a direct amortization of debt at par, this will not be counted as a debt reduction according to the definition in the text.

past couple of years, Bolivia remains the only country that has eliminated a large proportion of its debt obligations through a debt reduction program (in this case, through a buyback of debt at a deep discount).[5] In other countries, of which Chile is the most notable, debt reduction has come in a piecemeal fashion, mainly as part of debt-equity swap programs, and indirect debt repurchase agreements.[6] Ironically, we will stress that debt-equity swaps represent a kind of debt reduction that is typically of significant harm to the debtor country, which helps to explain why most countries have cancelled or very sharply limited their programs by this point. Moreover, much of the actual debt reduction that has taken place has involved private-sector debt, rather than the restructured public sector debt that is at the core of the debt crisis. Since the main source of the debt crisis is a financially distressed public sector, private debt conversions might be helpful, but are unlikely to play more than an incidental role in resolving the debt crisis.

In sum, when the banks advertise "more than $26 billion" of debt reduction,[7] the vast bulk of this amount is private sector conversions (approximately $8.0 billion), and debt-equity swaps and local conversions (approximately $16 billion), versus only about $2 billion of debt buybacks and exit bonds for public sector

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[5]See Sachs (1988b) for a detailed discussion of the Bolivian debt buyback.

[6]See Felipe Larrain (1988) for a detailed discussion of Chile's experience with debt reduction mechanisms.

[7]See the Institute of International Finance, op.cit., p. 21.

debt. The vast bulk of debt reduction has come in distinctly unhelpful form, not the kind that is at the center of this paper. Note too that many creditor banks have substantially reduced their LDC exposure by selling their claims in the secondary market to other institutions that now hold the debt. Such operations reduce the debt holdings of the banks, but do not reduce the debt of the debtor countries, since they merely transfer the ownership of the claim to another creditor.

The gap between the rhetoric of debt reduction and the harsh reality of debt negotiations for the debtor countries has never been greater. In the past two years, debt restructuring programs have done little to satisfy the financial needs of the debtor countries. Only four new money packages were negotiated in the past two years, and all have by now collapsed. In fact the banks have become increasingly aggressive in recent negotiations, unrestrained by any discipline of public policy. The banks pressed for extensive debt-equity swap programs and relending provisions for Brazil, thus contributing markedly to Brazil's hyperinflation, while providing inadequate refinancing of interest. Citicorp praised the Brazilian agreement as the most innovative to date, only to see its major provisions collapse in a matter of 3 months.[8]

The theme of this paper is simple. The failure in the last two years to make real headway with debt reduction is not an

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[8]See William Rhodes, "An Insider's Reflection on the Brazilian Debt Package," Wall Street Journal, October 14, 1988.

accident. Even when a reduction of the debt burden would be beneficial to the broad class of creditors and debtors alike, it is unlikely to emerge from the current structure of debt negotiations. Meaningful debt reduction requires an appropriate institutional setting to overcome important collective action problems. In the domestic economy, bankruptcy law provides the framework for organizing the collective interests of the creditors in a situation of financial distress of a debtor. In the international setting, no such institutional framework yet exists.

What is worrisome about current discussions is the apparent failure to recognize these serious institutional limitations to debt reduction. Almost all of the new-found advocates of debt reduction in the creditor community put enormous stress on the fact that debt reduction should be "voluntary" and "market based", without paying serious attention to the extent of debt reduction that is likely to be achieved according to these guidelines.[9] Under the current incentives, voluntary debt relief is bound to mean no more than a continuing nibbling away at the edges of the debt overhang, without real relief for the debtor or real benefits for the creditors.

I will stress that instead of "voluntary" debt reduction, we instead need "concerted" debt reduction. Again, some definitions

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[9]Advocates of voluntary debt reduction (VDR) envision that debt reduction should be achieved through the transactions in which each bank creditor may choose whether or not to participate. Example of VDR include the purchase of debt for cash (in buybacks), or the creation of new financial claims (e.g. exit bonds, debt-equity swaps) which each bank creditor can voluntarily choose to accept in exchange for the existing debt.

are in order to understand this point. By "voluntary", it is usually meant that each bank should be able to decide whether to participate in a debt reduction scheme (e.g. each bank chooses whether to accept a given exit bond in a swap for the existing debt). I will contrast this case with "concerted" relief, in which <u>all</u> of the banks jointly participate on a fairly equal basis. It has long been recognized that in the case of new money packages, a "concerted" arrangement rather than a "voluntary" arrangement is needed. The same is true with respect to debt reduction.

The banks have some rhetorical success in stressing the need for "voluntary" programs, since it appears that the opposite of a "voluntary" program must be a coercive program, which sounds unfair. Voluntary debt relief seems to be morally unassailable. But, in truth, the issue is not whether debt reduction should be coercive or not; the issue is whether <u>all</u> banks should commit to participate in any given debt reduction arrangement (as the banks have repeatedly decided in the case of new lending). This paper envisions a <u>negotiated, concerted form of debt relief</u>, that would parallel the kind of concerted settlement found in a bankruptcy proceeding, and found in "new money" packages.[10]

A simple mechanism is at hand to achieve concerted debt reduction. <u>The existing debt should be rescheduled at sub-market</u>

[10] At the risk of belaboring the point, I distinguish "voluntary" from "concerted", and "negotiated" from "unilateral". A meaningful solution will have to be negotiated, rather than unilateral; but it will also have to be concerted, rather than voluntary (as that term is now used).

interest rates, where the rates are guided by various indicators of ability to pay, and are decided in negotiations between the debtor country and the creditor banks.[11] This simple mechanism would treat all banks symetrically, facilitate a substantial amount of debt reduction, and be easily accomplished both legally and administratively. In addition to lowering the interest rates, the interest payments could be made more secure for the banks through various means, including collateralization, guarantees by the official creditor community, and escrow accounts in which export earnings are deposited for the purpose of future debt servicing, and so forth. These alternative forms of credit-enhancement are at the core of several proposals for debt reduction, and could in fact be flexibly applied on a case-by-case basis.

The kind of interest-rate reduction suggested in this paper could be easily managed in the context of an international debt facility, which is one form of instituting a global approach. I will not focus further on the facility itself (details may be found in Sachs, 1988), focussing instead here on the problems of debt reduction for each particular country.

One more important point about debt reduction should be stressed at the outset. Meaningful debt reduction will require the active participation of the international community. The IMF and World Bank will have to provide technical guidance concerning

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[11]The international agencies would have an important role in providing indicators of debt service capacity.

the appropriate levels of reduction; the international community will play a role in structuring the negotiations; and the international community might provide crucial credit enhancement as part of the debt reduction mechanism. The official role in any debt-reduction agreement should be predicated on the debtor country's participation in an ongoing, internationally supervised adjustment program, subject to strong conditionalities. Debt reduction must be matched by responsible policymaking in the debtor country. As I will stress, the prospect of achieving debt reduction can by itself be an important spur to good policymaking.[12]

The paper proceeds as follows. Section 2 describes briefly the efficiency arguments concerning debt reduction, and provides some circumstantial evidence in support of the basic theory. It also stresses why the existing approach of "new money packages" is bound to fail. Section 3 highlights the reasons for the general ineffectiveness of "voluntary debt reduction" mechanisms, both on a theoretical and empirical basis. Section 4 argues that concerted debt reduction, brought about through sub-market interest rates and with various forms of credit enhancement,

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[12]One of the myths about debt reduction is that it would reduce the incentive for reform. This point of view hardly seems compelling after 6 years of a "tight leash" approach in Latin America has left the region in a shambles. The prospects of debt reduction could do enormous benefit in mobilizing the support for reform, as I shall stress. Moreover, all official credit guarantees on restructured debt should be appropriately protected through conditionality, and failures of governments to pay the reduced debt (thereby triggering the official guarantees) can be met with stiff sanctions.

offers the simplest, most realistic, and most efficient form of debt reduction. Section 5 presents some conclusions.

2. The Basic Efficiency Case for Debt Reduction

Under certain circumstances, debt reduction can improve the welfare of creditors as well as debtors, because a large overhang of debt can worsen the economic performance of the debtor and thereby diminish the expected returns of the creditor. This point is well known in the literature on corporate bankruptcy (see Jackson, 1986), and was first stressed in the context of sovereign debt by Sachs (1986). Bankruptcy law is also founded on the proposition that efficient debt reduction will normally not occur in a decentralized market process, since each individual creditor has the incentive to press for full payment on its own claims, even if collectively it would be in the collective interests of the creditors to reduce the debt burden. The bankruptcy settlement cuts through this fundamental collective action problem by enforcing a concerted settlement on the creditors.

The efficiency gains from bankruptcy are seen most vividly in the case of corporate reorganization (Chapter 11 of the U.S. Bankruptcy code). The main idea of corporate reorganization is that a highly indebted firm (with negative net worth) may be worth more to the creditors if it remains a going concern rather than being forced into liquidation, and yet the individual actions of creditors (in the absence of bankruptcy protection) might force the firm into liquidation as the individual creditors race to seize particular assets of the firm. Less dramatically, even if the existing creditors exercise forbearance in liquidating the firm, the overhang of debt (in the absence of bankruptcy protection) can by itself cripple the normal operations of the firm by: restricting access to trade financing; hindering the maintainance of long-term suppliers relations; raising the cost of collecting debts that are owed to the firm; and limiting the access of the firm to the long-term capital markets.[13]

In a typical corporate reorganization, it is recognized that the continued efficient operation of the firm requires that the debt burden be reduced to manageable levels, in order to avoid the risks of decapitalization as well as the various inefficiencies of a debt overhang. Thus, while a bankruptcy proceeding "forces" the individual creditors to give up part of their legal claims, and indeed reduces the contractual obligations of the debtor, it does so for the benefit of the creditors, by preserving the capacity of the debtor to function effectively and thereby to service as much of the debt as possible.

The process of bankruptcy (and specifically the reduction of the debt claims on the firm) will typically restore the access of the firm to the capital markets, both for short-term trade financing, and for long-term borrowing for fixed capital investment. It is common in a bankruptcy action that once the existing debts are reduced, the bankrupt firm may <u>immediately</u>

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[13]All of this is discussed at great length in Jackson's (1986) outstanding analysis.

return to the credit markets for new financing based on a cleaned-up balance sheet.[14]

Seen in this light, the most common argument against debt reduction made by the creditor banks seems perverse. It is sometimes argued that debt reduction for a sovereign borrower is harmful to debtor because it will block the return of the sovereign to the loan market. In fact, it is the debt overhang itself that prevents the return of the sovereign to the loan market, and the most effective way to revive lending for trade financing and fixed capital formation is to reduce the debt burden to a level that can be serviced by the debtor.

Those who argue against debt reduction because of an alleged adverse effect on future lending confuse the effects of two kinds of actions on the debt. A unilateral and hostile suspension of payments by a debtor may indeed delay the debtor's return to the capital markets.[15] Contrariwise, an agreed and negotiated reduction of debt can speed the return of the sovereign to the capital market. Note, for example, that Indonesia had access to commercial market borrowing just four years after Indonesia's debts to foreign governments were substantially reduced in 1970. The alleged reputational onus against a government that failed to honor its debts simply did not exist in this case. If the creditor

[14] A recent example is the case of the bankrupt Washington Power Supply Company, which settled with its creditors in December 1988, reducing their claims substantially, and then returned to the capital markets immediately with significant new borrowing.

[15] It may still make sense as a measure of last resort, however.

banks are truly worried about a sovereign's future access to lending, then the banks should strive to reduce the debt burden via negotiation, rather than cornering the debtor into the need for unilateral actions.

There is a resistance in many quarters to interpret debtor countries as being in a state of bankruptcy. Many observers, starting with Cline (1983), have interpreted the debt problem as a liquidity problem rather than a solvency problem. Others, in the tradition of Eaton and Gersovitz (1981), view the issue as a problem of "willingness to pay", rather than ability to pay. In fact, the whole question of whether the debt poses a liquidity, solvency, or willingness-to-pay problem has turned out to be rather sterile. From a purely technological point of view, there is no doubt that the countries are solvent: given <u>existing technologies and national resources</u>, the debts could surely be serviced in the long term.

Even so, most governments will be unable to service the debts in entirety, if they want to.[16] The debt is mostly owed by the public sector, where political, economic, and administrative limitations to debt servicing present a profound barrier to debt servicing. Budget cuts or tax increases needed to muster public resources for debt servicing may be opposed in Congress; tax administration may be highly inefficient, and incapable of quick reform; the realities of political competition, with the risks of

[16]More specifically, even if the President and his economics teams wants to service the debt.

electoral defeat, may frustrate a government that attempts to service the debts in full;[17] the austerity provoked by debt servicing may lead to insurrection and domestic unrest. From the point of view of the economics team in the government, the situation typically looks much more like an "inability" to pay, rather than an "unwillingness" to pay.

There is in fact prima facie evidence for applying the lessons of bankruptcy to the case of the sovereign debt overhang. The single biggest failure of the debt management process to date is the progressive decapitalization of the debtor countries, just as is predicted by the analysis of how creditors will behave in the absence of a collective debt reduction mechanism. This decapitalization is evidenced anecdotally by events such as the electrical blackouts in Buenos Aires in early 1989, which reflect not only unforseen disturbances, but also years of underinvestment in energy facilities. The decapitalization is more generally evident in statistics showing the remarkable drop-off in the rate of capital accumulation in the countries with debt servicing problems, as shown in Table 1. This decline in investment is blocking the effective recovery and growth of the debtor countries, to the disadvantage of creditors as well as debtors.

Though there are many factors in this decline in investment rates, at least some are importantly related to the debt overhang.

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[17]For instance, a congressional party may split with the President in voting for austerity measures, for fear of electoral consequences. The President and a small set of cabinet ministers may then be left virtually isolated in pushing for economic reforms, as has occurred in Argentina.

Table 1

Gross Capital Formation in Countries with and without Debt-Servicing Problems (percent of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987
Countries with Debt-Servicing Problems	25.5	24.7	22.6	19.0	18.4	18.6	19.0	18.4
Countries without Debt-Servicing Problems	27.9	27.9	26.9	26.5	26.5	27.8	27.4	27.2

Source: IMF World Economic Outlook, October 1988, Table A7, p.66

Countries in debt-servicing difficulties have lost access to new international capital market lending even for incrementally profitable investments in the private sector (and certainly the public sector); they have suffered a significant reduction of foreign direct investment; and they have lost access, in many cases, to normal short-term trade financing. Importantly, the decline in investment in the heavily indebted countries exceeds decline in net resource transfers from abroad in recent years, suggesting that investment has declined not only because of the lack of foreign resources, but also because of the more general disincentives against investment in the debtor countries created by the debt crisis itself.

Though most observers recognize the seriousness of the decline in investment rates, there is a considerable divergence in views as to whether debt reduction is really a necessary condition for a substantial improvement in investment rates, and whether debt reduction could actually benefit the creditors by spurring enough investment to raise the eventual servicing of the debt. One school of thought holds that higher investment should be financed by a reduced the net resource transfer out of the HICs brought about mainly through new lending instead of debt reduction; a second school of thought holds that the net resource transfer should be cut mainly through debt reduction.

The "new money" school of thought holds that the inefficiencies of the debt overhang can be kept under control without the need for a formal reduction of the debt. Defenders of this position used to argue that the debt crisis was merely a short-term liquidity problem, and the after a bit of bridge financing the countries would soon return to the capital markets. Now, defenders of this viewpoint suggest that we don't really know whether the problem is liquidity or solvency,[18] but that until we find out conclusively we can nurture the debtors along with new loans and thereby avoid the high costs of a debt overhang.[19] In essence, the debt-rescheduling process is called upon to mimic the case of actual debt relief by providing enough "new money" so that the debtor pays no more in actual cash flow than it would in the case of actual debt reduction, but does so through a combination of larger debt repayments balanced by new lending.

2.1. Why the "new money" approach will continue to fail

In practice, the rescheduling process never has, and almost surely never can, come close to mimicking the benefits of actual debt reduction. This is for several reasons. First, new lending requires a collective action on the part of creditors that is no longer achievable except on rare occassions in the case of the very largest countries. The process of negotiating new money is very costly, and inevitably so, in that it is prone to breakdowns, inadequate levels of financing, long and costly delays, high-

[18]With solvency considered in the expanded sense, of recognizing the government's limited political resources to muster debt servicing capacity.

[19]Bulow and Rogoff (1988) suggest, for example, that the current negotiating process has resolved most of the inefficiencies in debt management.

stakes brinksmanship, and so forth. Second, even if the existing creditors agree to refinance a significant proportion of payments that are due, new creditors are still blocked from participating in new lending on a decentralized basis, for fear of having their new loans become part of the overall bad debt. And third, refinancing (rather than debt reduction) causes a build-up of future debt that may adversely affect the incentives of current investors, mainly the debtor governments. Let us consider each of these points in turn.

First, the rescheduling process has all but broken down. There are at least 42 countries that have rescheduled their debts with commercial banks in recent years.[20] Of these, only four countries were able to negotiate new money agreements in 1987-88: Argentina (1987), Brazil (1988), Ecuador (1987), and Ivory Coast (1988). Every one of these agreements has come to naught. As of January 1989, the Argentine agreement has completely collapsed,

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[20] These are listed in Table III-5 of the World Bank World Debt Tables, 1988-89 Edition. The countries, in alphabetical order, are as follows: Argentina, Bolivia, Brazil, Central African Republic, Chile, Congo, Costa Rica, Cote d'Ivoire, Cuba, Dominican Republic, Ecuador, Gabon, Gambia, Guyana, Honduras, Jamaica, Liberia, Madagascar, Malawi, Mexico, Morocco, Mozambique, Nicaragua, Niger, Nigeria, Panama, Peru, Philippines, Poland, Romania, Senegal, Sierra Leone, Somalia, Sudan, Togo, Turkey, Uganda, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia. One country, Turkey, has reestablished normal market creditworthiness after falling into a debt crisis. One other country, Colombia, has not rescheduled, but does not have normal market access to new lending. After a prolonged negotiation, Colombia and the creditor banks agreed in late 1988 to a new money package of $1.7 billion. Notably, to the consternation of the Colombian government, this new money package does not even fully refinance amortization payments (which are about $2.1 billion), and therefore refinances none of the interest payments due.

with Argentina in arrears for more than 9 months; the Brazilian agreement has collapsed in important part, with various provisions unilaterally suspended by Brazil and with the prospects for drawing the next credit tranche very slim; the Ecuadorian agreement was never implemented, because the banks did not subscribe an adequate amount of money, leading Ecuador to suspend the provisional agreement; and the Ivory Coast agreement also was not implemented, and the country remains in deep arrears.

For most of the other debtor countries, the absence of a new money agreement signifies the collapse of adequate financing. The following countries were in arrears on interest payments as of January 1989 (this list is almost surely not comprehensive): Argentina, Bolivia, Costa Rica, Cote D'Ivoire, Dominican Republic, Ecuador, Guyana, Honduras, Liberia, Nicaragua, Nigeria, Panama, Peru, Sudan, Zaire, and Zambia. Many other countries are not in arrears, but have been unable to negotiate new money agreements. For example, Yugoslavia renegotiated its bank debt in 1988 but received no new financing (despite a presumptive need for external financing suggested by a 250 percent annual inflation rates).

This situation is unlikely to change, since the banks have become less willing over time to participate in these packages. The Washington-based Institute of International Finance, which lobbies on behalf of the banks, made this point explicitly in a letter to the IMF last fall, when it announced that it would be "unable" to provide $6-9 billion of loans per year. Since this would reflect <u>less than 2 percent</u> of existing exposure, the banks are announcing that they will not refinance even one-fifth of the interest due from the debtor countries. Since the vast bulk of any new money will inevitably go to Argentina, Brazil, and Mexico, there is essentially no refinancing available for the smaller 25 to 30 countries now in financial distress.[21]

The IIF letter was not simply a negotiating ploy. The decline of actual agreements reached in 1987-88, and the fact that all have broken down in short order, is one kind of evidence. Another is the fact that the U.S. banks in droves are now selling off their Latin exposure, as shown in Table 2. I will stress below the important point that the smaller banks are divesting at a more rapid rate than the larger banks, but the key point here is that all banks are getting out of the term-lending business, and the capacity to put together realistic agreements (which last for more than three months at a time) has virtually disappeared. And despite the rhetoric even the banks with the most extensive foreign operations are leaving the scene: Bank of America will be sharply contracting its international operations in 1989.

The only possibility for substantial amounts of new money would be for a major increase in official creditor lending (for example, the banks are now pressing hard for public guarantees of new private bank lending). Such a shift of lending from the banks to the official creditors would be a politically untenable bailout

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[21]In their new report, "The Way Forward for Middle-Income Countries", op. cit., the IIF states, "In short, for many bankds the benefits of maintaining the current collective strategy [of new money] have diminished, while most banks' willingness to make new loans to troubled debtors has declined." (p.16)

Table 2

Reductions in LDC Exposure at 29 Banks Selected Among the Largest

	Total LDC Exposure in Millions (unless otherwise noted) June 87	Sept 88	Exposure Reductions June 1987 to September 1988	
Citicorp	$14,600	$12,100	$2,500	17%
BankAmerica	10,354	9,000	1,354	13%
Manufacturers Hanover	9,234	8,688	546	6%
Chase Manhattan	8,740	7,950	790	9%
Chemical Banking	5,945	5,900	45	1%
J.P. Morgan	5,400	4,700	700	13%
Bankers Trust	4,000	4,000	0	0%
First Chicago	3,120	2,429	691	22%
Continental Illinois	2,400	2,000	400	17%
Irving Bank Corp	1,950	1,890	60	3%
Mellon	1,600	1,386	214	13%
Security Pacific	2,200	1,260	940	43%
Bank of Boston	1,400	1,000	400	29%
First Interstate	1,606	996	610	38%
Wells Fargo	1,909	760	1,149	60%
Bank of New York (a)	544	470	74	14%
Republic of New York	487 E	461 E	26	5%
PNC Financial (c)	481 E	291	190	40%
First Fidelity (b)	237	177	60	25%
Northern Trust (a)	321	149	172	54%
Southeast Banking (b)	215	117	98	46%
MNC Financial	223	107	116	52%
Bank of New England	307	106	201	65%
Valley National	155	62	93	60%
Fleet/Norstar	145	52	93	64%
First Wisconsin	289	17	272	94%
Norwest Corp. (b)	515	16	499	97%
First Wachovia	212	8 (d)	204	96%
NCNB Corp.	247	4	243	98%
	$78,837	$66,095	$12,742	16%

(a) Includes loans only
(b) Includes non-trade-related credits only
(c) Includes medium- and long-term LDC loans only
(d) The exposure totals at these dates were fully reserved against

NOTE: Exposures only in dollars (and not in local currency) are included
E = Estimate

of the commercial banks, if it were not combined with significant concessions from the banks themselves. Such new lending would almost surely run up against strong political opposition in the U.S., unless the new official lending were visibly tied to debt reduction (e.g. through official guarantees of exit bonds). There was considerable Congressional opposition to the General Capital Increase of the World Bank in 1988 on the grounds that it represented a thinly veiled bailout of the money-center banks.

Even if "new money" became available to cover interest payments, it would not overcome the inefficiencies of the debt overhang. A reduction of debt via bankruptcy is helpful not only becauses it reduces the repayments due from debtors to creditors, but also because it allows new creditors to enter into agreements with the bankrupt firm on a normal market basis. Similarly, with a heavily indebted country, the overhang of public sector debt puts a damper on a vast range of financial relations between residents of the country and the international capital markets. For example, most of the smaller HICs have lost access to normal trade financing, since banks fear that even short-term trade lines will be subject to transfer risk. While the data are not available to establish this point generally, it is certainly the case in Bolivia, Costa Rica, Ecuador, and Peru, and probably in most other problem debtor countries.

The final reason that the "new money" approach is bound to fail is that even if much greater short-term cash flow relief could be provided by new money, and even if the problem with new creditors could be overcome, the debt overhang would almost surely create extremely adverse incentive problems for the debtor governments in regard to their decisions on public investment and economic reform. Governments would continue to have a hard time justifying tough reform measures to the extent that such reforms seem designed to increase future debt servicing payments abroad. As stressed by Sachs (1987,1988a,1988b), such reform measures are almost everywhere in Latin America caught in a political stalemate, except in those countries that rule by repression or that have won a measure of effective debt relief (e.g. Bolivia).

Formal models of this incentive problem typically depict a government choosing between investing or consuming in the current period, to show that a debt overhang acts like a tax on future investment.[22] But the real problem is more serious than this. Even more pernicious than this incentive effect is the effect of the debt overhang on the electoral choices in Latin America. Candidates in favor of long-term reform in the present situation have little apparent to offer to the public: they promise to impose a burden today in order to carry out the reforms, and then implicitly to maintain the burden in the future when they service the foreign debt. Candidates with a shorter-term message, of debt moratorium and real wage increases in the current period, therefore have a much more attractive message to offer to large parts of the population. The result is a resurgence of populism

[22] See for example Sachs (1986), Corden (1988), and the discussion in Krugman (1988).

in Argentina, Brazil, Ecuador, Mexico, and Peru, that poses a significant danger to the possibility of long-term reform.

The creditor community has rarely shown an appreciation of the need for a compromise on debt reduction <u>for the sake of bolstering the moderate political factions that are most likely to service the debt.</u> All of the short-run pressures for reform by the IMF and World Bank count for nothing if the moderate political forces are unable to maintain power in Latin America's increasingly turbulent political environment. Actual debt reduction should be seen as an instrument for bolstering reformist political forces, not only so that they themselves have the incentive to undertake the right policies, but also so that they can win elections against candidates that promise easier solutions.

3. The Ineffectiveness of "Voluntary Debt Reduction"

The idea of debt reduction has been around for several years, but the actual accomplishment of debt reduction has been meagre. The main channel for debt reduction has been debt-equity swaps, which ironically are the kind of debt reduction that is typically harmful to the debtor country. In fact, despite the enormous pressure from the commercial banks for such programs, they have been suspended in almost every country that has introduced them, with the exception of Chile. Moreover, despite the dozens of commercial bank reschedulings since 1982, <u>there is not a single case of commercial bank debt being rescheduled at sub-market</u>

interest rates, despite the fact that many countries are almost universally acknowledged to be financial "basket cases" that have no possibility of fully servicing their debts on normal market terms.[23]

In this section, I will stress that the meagre record on debt reduction is an intrinsic feature of the bargaining process between the banks and the debtor countries, as it is now structured. Without a bankruptcy institution, and without the official creditor community attempting to design concerted agreements as in a bankruptcy court, real debt reduction will almost surely not be accomplished even with a broadened "menu of options" that includes more debt reduction mechanisms.

Debt reduction schemes should be measured against the standard of restored creditworthiness of the debtor country. Specifically, the debt reduction should be extensive enough to accomplish the following goals: (1) to allow the debtor country to service the external debt on the revised contractual basis without the need to refinance interest payments in new concerted lending packages; (2) to allow the private sector in the debtor country to attract suppliers credits, trade credits, and project finance, on a decentralized basis. If some partial debt reduction takes place

[23]Some countries in this category include Bolivia, Sudan, Nigeria, Peru. The absence of sub-market interest rate settlements is absolutely astounding in my view, and belies the commitment to a truly case-by-case approach. For the real basket case countries, those which have been declared "value impaired" by the U.S. regulators, there is no possibility whatsoever for a new money package, since such packages are virtually circumscribed by U.S. regulations, which would force immediate writedowns of the new loans granted to these countries.

but fails to accomplish these two goals, most of the inefficiencies discussed earlier will remain despite the effort of arranging the debt reduction. Also in that case, as Bulow and Rogoff (1988) have stressed, it is likely that official guarantees will cost a lot of public money with little benefit to the debtor country. As with a bankrupt firm, there is little sense in a reorganization of the debt if the firm is going to remain in acute financial distress.

Under "voluntary" arrangements, a small number of banks can frustrate a comprehensive settlement of a country's debt overhang. As shown in Table 3, of the 16 U.S. banks that held Bolivian exposure at the time of the Bolivian buyback (and that did not otherwise dispose of their debt in the secondary market), 13 banks sold out entirely, while the 3 largest creditors (Bank of America, Citicorp, and Morgan Guaranty) held on to most of their claims. Their motivation for holding on was mainly to avoid setting a precendent for other countries, but the implication for Bolivia are clear: these few banks, and several like them abroad, have so far frustrated a full settlement of Bolivia's debt problem.[24]

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[24]There is still an excellent prospect for completing the debt reduction in the Bolivian case, since the official creditor community supports a complete solution to Bolivia's problems, and since a very few banks are now the bottleneck to a complete solution. In any event, as described in Sachs (1988b), the Bolivian debt management process since 1985 (which includes a prolonged period of arrears on commercial bank loans, extensive official financial support, and the 1988 debt buyback) has given Bolivia crucial breathing space that has allowed an economic and political recovery to get underway in the country.

Table 3

U.S. Bank Participation in the Bolivian Debt Buyback

Bank	Exposure (in millions)	Total Sales Cash	Bonds
Bank of America	69.2	10.0	
Citibank	50.974	9.315	12.829
Morgan Guaranty	11.465	0.0	
Manufacturers Hanover	7.984	7.984	
Bankers Trust	7.359	7.359	
Wells Fargo	6.311	6.311	
AMEX Bank Ltd.	4.55	4.55	
First Penn. Bank	4.116	4.116	
Atlantic International Bank	3.616	3.616	
Chemical Banking	3.105		3.105
Texas Commerce Bank	3.092	0.0	
California First Bank	2.86	2.86	
AmSec Bank	2.23	2.23	
Irving Trust	1.417	1.417	
Shawmut Bank	0.955	0.955	
NCNS (Nat'l Bank of N. Carolina)	0.907	0.0	
Allied Bank Int'l	0.295	0.295	
Seattle - First National	0.177	0.177	

Note: In the Bolivian buyback, banks could swap existing debt for cash (at 11 percent) or for investment bonds (which can be used for debt-equity swaps, and are redeemable in bolivianos for the boliviano equivalent of 16.5 of the face value of the debt. All of the banks except for Citibank, Bank of America, Morgan Guaranty, and Texas Commerce Bank, sold or swapped 100 percent of their portfolios.

There are several barriers to comprehensive[25] debt reduction, even with more extensive use of "voluntary" methods that are now supported by the official creditor community (e.g. buybacks, exit bonds, and debt-equity swaps). These barriers are: (1) the inherent collective-action barrier to comprehensive debt reduction; (2) the problem of precedents; (3) the problem of public sector bailouts; (4) the distorted incentives of the large banks; (5) the structure of the bargaining cycle.

It is useful to examine each of these barriers in turn.

3.1 The inherent collective-action barrier of voluntary schemes

In a "voluntary" debt reduction mechanism, each creditor is free to choose whether to participate or not. Non-participation means that the creditor continues to hold the original claim, and can attempt to collect as much as possible on that claim. Thus, there is a basic arbitrage condition which attaches voluntary schemes: participation in the scheme must, on the margin, be no worse than holding out, and sticking with the original claim. Thus, in a voluntary scheme, the creditor must compare the value of the existing claim <u>after the debt reduction has taken place</u> with the value of the alternative claim that is available through participation in the debt reduction scheme.

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[25] I will use "comprehensive" debt reduction as debt reduction that is sufficient to obviate the need for concerted lending packages, and sufficient to allow for a restoration of trade credits and project financing for the private sector.

But now an obvious paradox arises, which is best illustrated in the case of certainty. A full restoration of creditworthiness would imply that all claims on the debtor, including "old" debt which does not participate in the debt reduction process, will rise in value to its face value. The secondary market price of the old debt will be 100 cents on the dollar after the debt reduction, if full creditworthiness is indeed restored.[26] Thus, under certainty, there would be no motivation for an individual creditor, that has a small share of the overall debt, to participate in a voluntary scheme if the creditor receives something less than 100 percent of face value.

The result, which is proved formally by Helpman (1988) for example, is that voluntary debt reduction may be impossible as a market equilibrium <u>even when the creditors as a whole would benefit from the debt reduction relative to the status quo.</u> Thus, the insistence that debt reduction be voluntary actually <u>hurts</u> the creditors as a whole. It probably helps, however, a small part of the creditor group (the large money-center banks), a point that we stress below.

The same point can also be made from the point of view of the international institutions, as has been done by Dooley (1987). It may be prohibitively costly to use official money for a buyback, or for other forms of credit enhancement, in a purely voluntary debt reduction arrangement, since the cost of restoring

[26]Note, importantly, that this illustration is considering the case of certainty only; with uncertainty, market creditworthiness may be consistent with a discount on the face value of the debt.

creditworthiness becomes virtually the entire face value of the debt in the case that the individual banks can freely decide whether to opt in or opt out.

The fundamental distortion of voluntary debt reduction schemes is recognized by the banks, even though they fail to understand its analytical importance, or its implications for the failure of the voluntary approach. The IIF has recently written (op. cit., p. 23), that "the cost [of debt reduction] is the discount incurred in exchanging old assets for new assets, but the benefits accrue to all creditors and to the debtor country because its external debt servicing costs are reduced. Thus, particular creditors benefit if other creditors can be induced to reduce their claims." This externality is praised by the IIF as an added benefit of voluntary debt reduction, rather than as the profound barrier to efficient debt reduction that it is in fact.

The key to efficient debt reduction is to require the creditors to exercise their own self interest by participation in a concerted debt reduction scheme. The appropriate test for a concerted debt reduction scheme is whether the creditors are made better off than in the status quo. By this test, the banks should compare the secondary market price of the debt before the debt reduction with the value of the asset that they would receive in the concerted debt reduction scheme.

3.2 The problem of precedent

Among the banks and the U.S. Treasury, almost the entire debt process is conceived of in terms of no more than five countries: Argentina, Brazil, Mexico, the Philippines, and Venezuela. While there are at least 42 countries that have rescheduled their commercial bank debts in recent years, the five main debtors account for about 80 percent of the exposure of the nine money-center U.S. banks to all 42 countries. The top three countries (Argentina, Brazil, and Mexico) alone count for 64 percent of the total exposure of the money-center banks to the problem LDCs. Importantly, however, from a humanitarian and geopolitical point of view, the five countries count for only 40 percent of the population of the entire group.[27] In the debt management process, there is little serious attempt to address the problems of the smaller debtor countries for fear of setting adverse precedents for the larger countries. There is also no new money for these countries. The arguments that the banks use for opposing debt relief (e.g. that they are in the countries for the "long haul"; that the countries can successfully service their debts in the long term; that the countries will want to return to commercial bank lending in the near term), manifestly do not apply for many if not most of the smaller debtor countries. Countries such as Bolivia, Dominican Republic, Ecuador, and Peru, among others, cannot pay their bills; are in no condition to expect a return to

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[27] In geopolitical terms, it should be remembered that even a country of 3 million people, Nicaragua, with an insignificant proportion of the foreign debt, virtually dominated U.S. foreign policy attention in Latin America in recent years. And of course, Nicaragua's political crisis in the 1980s was crucially tied to the economic crisis in the country in the 1970s.

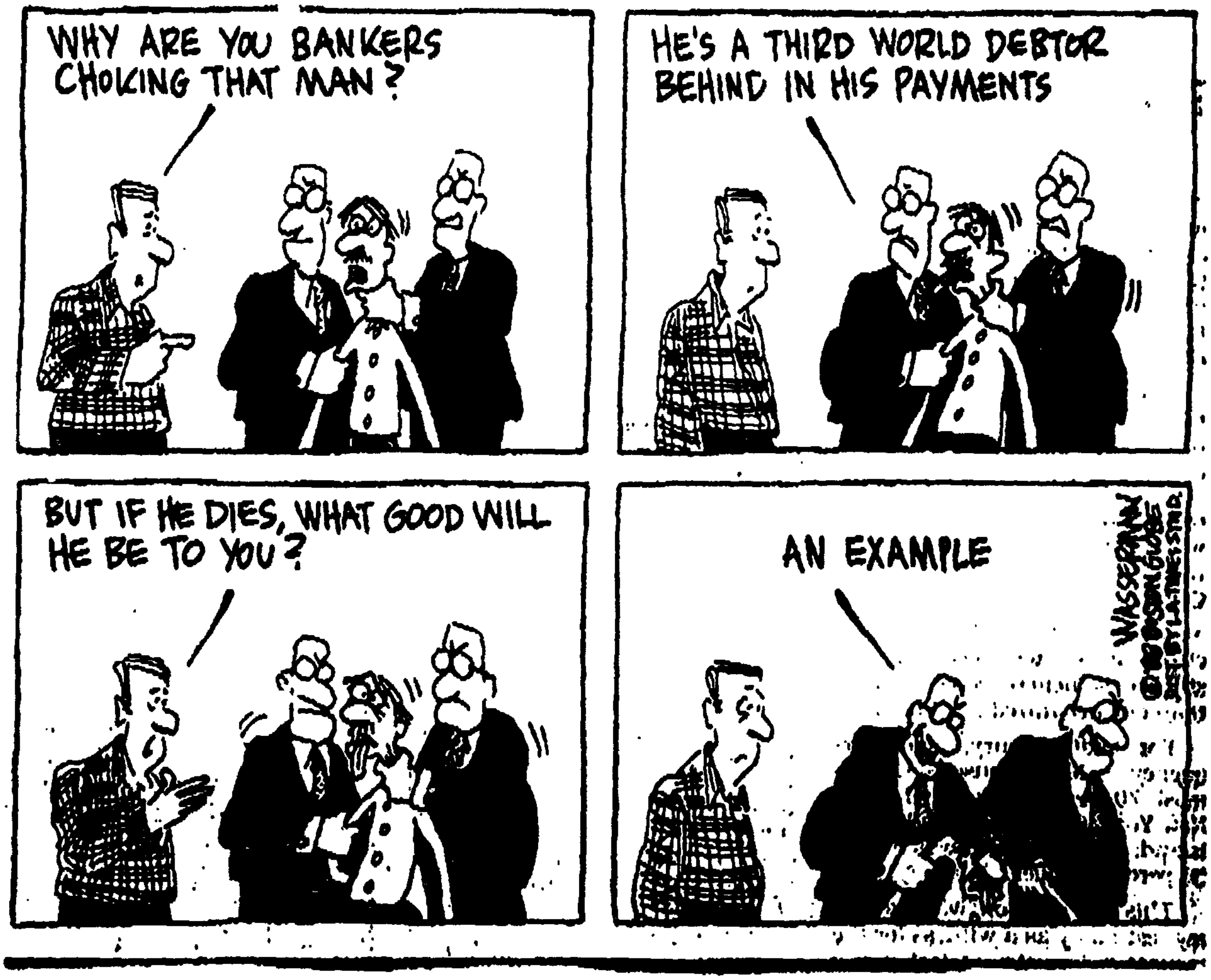
commercial bank lending for a great many years; and do not expect a continuing presence of the money-center banks in their countries. And yet for these countries, as much as for Argentina, Brazil, and Mexico, comprehensive debt reduction has been off the agenda.

The reason is not hard to decipher: it may be found in Cartoon No. 1 on the next page. The small debtor countries have so little debt that there is almost nothing to gain for the big banks in reaching a more efficient solution for them, while the risk of a precedent might be very damaging. The smaller countries are truly worth more as an example.

Thus, in the case of Bolivia, the money-center banks have held on to their claims, even as all of the rest of the U.S. banks have abandoned theirs. There is still a good chance fcr a comprehensive settlement in Bolivia (as is supposed in the IMF and World Bank programs for the country, and has been committed by key banks in the steering committee), but only after overcoming significant money-center bank resistance to the risk of a precedent. Bolivia's needs at this point have relatively little to do with the strategy of the big banks vis-a-vis the Bolivian debt.

3.3 The expectation of public sector bailouts

The third major reason why comprehensive debt reduction is unlikely is the continuing signal from the official community that public money will come to the rescue of the faltering



Boston Globe, 10/3/88

renegotiation process. The banks and the debtor countries are certainly not the only players in the debt-renegotiation game. The official creditor community has a major stake in the process, one that is well understood by the largest commercial banks.

The money-center banks are essentially in the position of Stackelberg leaders vis-a-vis the official lenders (including the Treasuries of the G-7 countries, the IMF, the World Bank, and the multilateral development banks). To the extent that the banks limit new lending or debt reduction, they know that the official community will make up at least part of the difference in official lending to the debtor countries. This is because the official creditors have an important stake in maintaining political and economic stability in the debtor countries, and thus are willing to put money into the process if the banks do not.

<u>This infusion of public money acts as a tax on debt reduction schemes</u>. It is easy to show that if the official creditors decrease their contributions to a debtor country for each dollar increase of debt relief from the private banks, the banks will have the incentive to underprovide debt reduction, at the expense of both the official creditors and the debtor country.

This process is increasingly evident. In Sachs (1988b), it is shown that the official creditors have systematically put net resources into the major debtor countries while at the same time the commercial banks have systematically removed net resources. In the Paris Club, the official bilateral creditors have virtually stopped collecting money: almost all countries are now able to negotiate rescheduling agreements in the Paris Club in which 100 percent of interest and principal is postponed for several years. The terms are substantially more favorable than those given by the commercial banks, despite the debtor's commitment under the terms of the Paris Club to negotiate terms with other creditors with terms at least as concessional as the terms offered by the Paris Club creditors.

The process of substituting official finance for bank finance has become more explicit over time. In recent months, for example, the U.S. Treasury has engineered a large bailout for Mexico, in which a large "bridge" loan was made ($3.5 billion) to future World Bank and IMF lending even though loan programs from those institutions had not been negotiated. The money was to guarantee a smooth transition period in which commercial bank interest payments would not be interrupted. More generally, the World Bank and the Government of Japan (especially via the Export-Import Bank) are widely seen to be acting as "lenders of last resort" to fill in the financial needs of large debtor countries that are not met in new money packages.[28] Similar Treasury loans are now under consideration for Argentina, Brazil, and Venezuela. The General Capital Increase of the World Bank, the recycling program of the Japanese Government, and anticipated quota increases for the International Monetary Fund and the InterAmerican Development Bank, are all viewed by the commercial

[28]This has become explicit in country negotiations, where the banks resist new money because they insist the financing gap can be made up with contributions from Japan and other creditors.

banks as important sources of money that will substitute for fresh bank lending in the coming years.[29]

3.4 The distorted incentives of the large banks

Despite all of the biases against debt reduction (e.g. the advantages of waiting for others to give relief; the problems of precedent; the prospects of an official bailout), most banks are now prepared to accept significant losses on the debt in return for ridding themselves of the problem. This is evidenced by the fact that the regional U.S. banks are now divesting of their entire LDC debt portfolios on the secondary market at a remarkable rate, with losses reaching 50-60 percent of the face value of the portfolios. It is a few money center banks, not the vast bulk of small and medium size U.S. banks, that are resisting comprehensive writedowns of their portfolios. Note in Table 2 that while most U.S. banks are reducing their exposure, the non-money center banks are reducing their exposure at a much faster rate.

It is important to analyze why the large banks are less willing to sell off their portfolios, since that also helps to

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[29] The IIF was quite explicit about this point in its public letter to the IMF and World Bank last fall. The letter said that the demand for bank financing "exceeds the capacity and willingness of banks to supply it", and continued with the statement that:

> The World Bank will have to accept a larger share of the overall lending risk by increasing its own disbursements, by offering banks better cofinancing opportunities and by taking the initiative to introduce other financing techniques, including limited interest payment guarantees.

See the report "Banks 'unable' to meet loan demands from Third World", Financial Times of London, p. 1, October 1988.

explain why the large banks have so vigorously resisted concerted debt reduction arrangements. The large banks typically argue that they should not be expected to accept the losses that are being accepted by the smaller banks, since the big banks unlike the small banks intend to remain in these countries for the "long haul". In other words, since the large banks are going to maintain business in Latin America, they should not be expected to accept losses on their existing debt; the smaller banks are selling off their portfolios because they are indeed getting out of Latin America entirely.

This explanation actually makes little sense on closer inspection. Citicorp could remain in Mexico for the "long haul" even if it agreed to cut interest rates on existing sovereign debt Mexican to sub-market rates! Indeed, in normal banking practices, it would be the bank with the long-term relationship with a client which would be expected to grant the concessions to the client in a case of financial distress. In Japan, for example, it is precisely the "main bank" (i.e. the bank with the long-term relationship, and largest exposure, with the client) that is called upon to grant sub-market interest rates in order to nurse a firm back into profitability in the case of financial distress.

The reasons for the large banks' greater resistance to debt writedowns has little to do, in fact, with their alleged long-term commitment to the debtor countries.[30] It has to do with three

[30]The extent of this long-term commitment is also not something to take at face value. Most banks, even large ones, are simply getting out of the sovereign loan business, and out of

other factors that should be deemed highly distortionary to the process of debt reduction. First, the large banks are resistant to writedowns because of the greater LDC exposure relative to capital. As we shall see, the higher exposure can cause banks to resist debt reduction even when the debt reduction is highly efficient in the sense of raising the expected present value of future debt repayments.

Second, the large banks have superior access to debt-equity swaps than do the small banks. In general, these debt-equity swaps offer a less costly way of divesting debt than does the secondary market. Thus, the big banks resist comprehensive agreements in order to maintain their options to pursue debt-equity swaps. Unfortunately, from the point of view of the debtor country, the debt-equity swaps tend to be highly deleterious.

Third, the large banks recognize that by slowing their own debt reduction process, they also gain by having the smaller banks "cash in", and accept losses via exit bonds, secondary market sales, and so forth. Since any creditor is made better off if another creditor voluntarily makes a concession to the debtor (since the remaining debt increases in value), the large banks have an added incentive to let the small banks get out at a large loss, while the big banks postpone any significant concessions. This is just another reflection of the collective action problem

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Latin America entirely. Citicorp is nearly alone in staying in Latin America in a significant way, but there is simply no sense to the idea that this bank alone should be exempt from sharing losses in a debt reduction agreement simply because it has highly profitable local operations in Latin America.

demonstrated at the beginning of this section.

Let us look at these three factors in a bit more detail.

3.4.1. Exposure ratios and the incentive to accept debt reduction

The money-center banks are more heavily exposed than the smaller banks in the U.S. At the end of 1987, the money-center bank LDC exposure to the 42 troubled debtor countries was $56.1 billion, or 109 percent of capital.[31] For the rest of the U.S. banks, the exposure was $27.3 billion, or 35 percent of capital. High exposure *per se* can be an important barrier to acceptance of debt reduction.

The key point is that regulatory oversight of the banks is based on the book values, not market values, of the banks' assets and liabilities. This means that heavily exposed banks may sometimes have the incentive to avoid *book* losses on their portfolio even if they represent *market* gains. A bank with a large exposure of LDC debt relative to bank capital might satisfy capital-adequacy requirements when measured at book values, but fail to satisfy them when measured at market value. In this case, the bank might turn down participation in a debt reduction scheme, even if it raises the market value of the LDC exposure, if at the same time it causes a book loss on the bank's claims that pushes the bank out of compliance with the regulatory guidelines on

[31]Calculations based on "Country Exposure Lending Survey: December 1987", of the Federal Financial Institutions Examination Council, April 22, 1988. By the end of 1988. the capital ratios have come down to well below 100 percent of bank capital.

capital adequacy.[32]

This kind of distortion arises because of faulty accounting procedures. In the U.S., the banks are not required to mark-to-market the valuation of LDC claims, so that the vast bulk of the claims is kept on the books at 100 percent of face value, despite a secondary market value of around 40 percent of face value.[33]

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[32] Consider the following example. A bank has total book assets of $1 billion, equity of $40 million, and deposit liabilities of $960 million, thus meeting the requirement of an equity-to-assets ratio of 4 percent. Of the $1 billion, suppose that the LDC exposure is $30 million in book (i.e. face) value, but with a market value of $10 million. The banks other assets are perfectly secure, with a market and book value of $970 million. The book value of the bank is $40 million, and the market value of the bank is $20 million ($10m + $970m - $960m). Now, suppose that a comprehensive debt reduction scheme comes into place, that reduces the face value of the debt to $15 million, and raises its market value to $15 million. If the bank accepts participation in the scheme, its book value would fall to $25 million, and the bank would sink below the 4 percent ratio on equity-to-assets. This would limit the regulatory independence of the bank (perhaps restricting its dividend issue; perhaps calling for intervention in bank management by the regulatory authorities). It is possible that the market value of the bank would fall because of the resulting regulatory intervention (in which case the bank management should reject the debt reduction deal on behalf of the shareholders). It is also possible that the market value of the bank would rise because of the increase in value of the LDC debt, but that the management would still reject the deal (contrary to the interests of the shareholders), because the resulting regulatory restrictions would hurt management even though it would not hurt the shareholders. In the latter case, the failure to enter into the debt reduction program would reflect a problem of accounting distortions combined with an "agency" problem in firm management.

[33]The banks are required to write down the value of the claims only in the case that the regulatory authorities, specifically the ICERC (Interagency Country Exposure Review Committee), declares that a country's assets are "value impaired", in which case the banks must set up an ATRR (allocated Transfer Risk Reserve), which effectively forces a writedown of the value of the debt. The ICERC has studiously avoided any writedowns for the major debtors, however, so that the ATRR is only required in a few cases of very small countries (including Bolivia, Costa Rica, Ecuador,

Banks are willing to absorb some losses on their LDC claims in order to clean up their portfolios, but only if such losses do not jeopardize the bank's plans for meeting the guidelines on capital adequacy, which are based purely on book values.

Thus, if we examine which banks have actually reduced their LDC portfolios the most (e.g. via sales in the secondary market), there is a very strong negative correlation between the exposure-to-equity ratio and the percentage decline in exposure in the past year. Using the data from Table 3, we find that on an unweighted average the nine money center banks have reduced their exposure by 10.9 percent, while the 20 banks with less exposure have reduced their exposure by an unweighted average of 49.8 percent.[34]

3.4.2. Large banks and debt-equity swaps

There are, moreover, several ways to reduce the LDC exposure, including participation in a comprehensive debt reduction scheme (e.g. the Bolivian buyback), sales directly into the secondary market, and participation in a debt-equity swap program. The latter offers banks the least expensive way to divest their LDC debt, since debt-equity swaps generally allow the creditor to avoid the full market loss implicit in the secondary market (the discount is shared between the debtor and the creditor). However,

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Nicaragua, Peru, Sudan).

[34]The nine money center banks are: Bank of America, Citibank, Chase Manhattan Bank, Manufacturers Hanover, Morgan Guarantee, Chemical Bank, Continental Illinois, Bankers Trust, And the First National Bank of Chicago.

effective participation in debt-equity swap programs generally requires a close working knowledge of the local economy that can be gained only through extensive operations in the country. Thus, the largest banks, with local branch networks, are best able to use the debt-equity swap programs to their advantage.[35]

The large banks, and especially Citicorp, have blocked comprehensive debt reduction arrangements in the past year (e.g. in Bolivia, Brazil, and Costa Rica), in order to press for expanded debt-equity swap programs. This is perfectly justifiable as a corporate strategy, but is highly distortionary from the point of view of a settlement on the debt issue. The main problem is that the debt-equity swaps by themselves are generally <u>harmful</u> to the countries undertaking them, since they imply <u>an acceleration of debt repayments rather than an easing of the debt-service burden</u>.[36] There are only limited circumstances in which

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[35]Extensive evidence from the income statements of the money-center and regional banks suggests that the largest banks (especially Citicorp) have been able to divest their LDC assets at a lower percentage loss than have the regional U.S. banks. Citicorp's stated losses in the past year have averaged between 20 and 25 percent of the reduction in LDC exposure, while for the superregionals, the loss has been on the order of 50 percent of the reduction in exposure. These data are from Salomon Brothers, "Citicorp -- Developing Country Debt Reduction Is Ahead of Schedule", October 20, 1988; and Keefe, Bruyette & Woods, Inc., "In the Southeast, 'LDC' Stands for 'Less Dire Consequences'", January 1989.

[36]In a debt-equity program, the debtor country repurchases the debt, usually at somewhere between the face value price and the secondary market price. Thus, instead of paying simply the interest on the debt (net of new lending), say a rate of 5 percent of exposure, the debtor government pays 70-80 percent of the exposure in order to repurchase the entire debt. This repurchase causes a worsening of the budgetary situation, and thereby contributes to inflation. Even if the monetary increase of the

debt-equity swaps may make economic sense: for private-sector debt, and in the case of privatisation of public enterprises (for which there are no inflationary consequences).

Not surprisingly, the largest banks have pushed relentlessly for these programs, while the debtor countries have typically restricted or cancelled them soon after they have come into operation. In the Brazil rescheduling agreement of September 1988, the Brazilian government committed itself to a debt-equity swap program in which the debt would be repurchased at face value, so that Brazil would not even benefit in the market discount via the program! Mercifully, the Brazilian government suspended this part of the agreement in January 1989. The amazing thing is that the official community, which should know better, has not opposed this kind of mechanism despite the harm to the debtor countries.[37]

A second problem with the debt-equity swaps is that, given their attraction to Citicorp and a few other banks, these large banks have frustrated more comprehensive arrangements (e.g. sub-market interest rates), for fear of jeopardizing the debtor countries' aquiescence in the debt-equity programs. Thus,

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repurchase is sterilized, the result is still likely to be a significant rise in the debt-service burden of the government (for an illustration with relation to Brazil, see Sachs 1989a). The repurchase terms are also generally far worse than a direct buyback on the secondary market. In Chile, for example, Larrain (1988) has shown that the Chilean government has captured <u>one third or less of the discount</u> on the secondary market, with the rest going to traders, foreign firms, participating banks, etc.!

[37]The Fed, for example, has gone out of its way to encourage debt-equity swaps, by amending Regulation K, for example, which governs the extent of equity participation that is allowed for a U.S. bank in an foreign firm.

comprehensive agreements have been held hostage to a form of debt reduction that is itself harmful to the interests of the debtor countries.

It is important to mention one further distortion which leads debtor countries into accepting these swap programs despite the highly adverse macroeconomic consequences. As stressed by Luiz Carlos Bresser Pereira, the former Finance Minister of Brazil, who faced enormous internal political pressures to implement such programs:

> The debt is a chance for speculation and profit. . .Formal and informal (through the parallel exchange rate market) debt-equity conversions make possible huge gains from speculation by some. The discount in the secondary market is shared by a number of people - bankers, brokers, investors, lawyers - and these people know that, if a global securitization scheme is adopted, they will lose this extraordinary source of gains.
>
> Actually it is possible to take two opposite views about the debt-equity conversions. You can think that this is a positive way of gradually reducing the debt, or you can think that this is a form of coopting the elites of the debtor countries, making their interests common to the interests of the major creditor banks. I am today firmly convinced that the second alternative is the correct one. These debt-equity swaps are based on the discount in the secondary market, that is, in the misery of many in the debtor countries whose incapacity to pay is so portrayed, but the one who make large profits from these conversions are a small, but influential minority in the debtor countries.[38]

3.4.3. The Large Banks' Incentive to Wait

The big banks have several fundamental reasons to avoid a comprehensive solution at this moment, mainly their heavy exposure

[38] Luiz Carlos Bresser Pereira, "Solving the Debt Crisis: Debt Relief and Adjustment", Testimony presented before the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives," January 5, 1989.

relative to equity, their expectation of official bailouts, and their preference for debt-equity swap programs. These two fundamental factors lead to a third, induced motivation for waiting. The smaller banks are now cutting their losses and getting out in separate side deals (e.g. buybacks and exit bonds). The money-center banks know that bv waiting, they reap advantages from the concessions of the smaller banks. John Reed, Chairman of Citicorp, was quite explicit on this point in a recent speech:

> What is happening right now is that some banks, like our own, are converting debt into long-term investments [i.e. debt-equity swaps]. At the same time, some smaller banks that have very different interests are selling out at prices that, frankly, <u>are quite convenient to those of us who are going to stay in for the long haul</u>, and quite convenient for the countries. (emphasis added).[39]

The waiting game imposes costs on the creditors as a whole (by allowing a continuing economic deterioration in the debtor countries), but these costs are borne by the smaller banks (who sell their debts at exceptionally discounted prices), not by the larger banks which impose the obstacles to concerted debt reduction.

3.5. The Problem of the Negotiating Cycle

Despite all of the resistance to comprehensive debt reduction on the part of the creditors, it still might be asked why the debtor countries do not have the bargaining power to achieve more

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[39]See John S. Reed, "Opportunities for the New Administration", remarks at the National Foreign Trade Council, New York, New York (October 18, 1988) and the Los Angeles World Affairs Council, Los Angeles, California (October 27, 1988).

comprehensive relief. The answer, it seems, lies importantly in the nature of the bargaining process. To put the matter simply, the countries have two objectives: (1) to remain on good terms with the official community, as a matter of foreign policy as well as financial policy; and (2) to reach better agreements with the creditor banks. As the negotiating process is actually carried out, however, it is virtually impossible to attempt the latter, without threatening the former.

The official community (i.e. the U.S. Treasury, the IMF, and the World Bank), expects debtor countries to reach negotiated agreements with the banks as a precondition for good official relations. When Brazil went into moratorium in 1987, for example, it was the withdrawal of _official_ financial support (e.g. export credits from the official agencies) that proved to do the most harm to Brazil's negotiating position. Similarly, the IMF almost always requires that the country reach an agreement with the commercial banks (at least in principle) before it will sign an IMF Standby. In turn, the IMF agreement is necessary for the country to reschedule its bilateral debts in the Paris Club, which is in turn necessary for the country to arrange new export financing from the export credit agencies of the creditor governments. The result is that the countries are pressed into signing commercial bank agreements, not mainly because of their bargaining weakness vis-a-vis the banks, but because an agreement with the banks has been made the _sine qua non_ of good relations with the creditor governments.

The only cases of real progress towards debt reduction (the Bolivian buyback in 1988, and Costa Rica, with a buyback likely in 1989) have occurred when the official creditor community has allowed the debtor country to maintain <u>good official relations</u> (e.g. to have IMF programs) during a period in which the countries were in prolonged arrears to the commercial banks. The implicit official sanction of the arrears both enabled the country to persist in long-term negotiations with the banks, and also sent a signal to the banks that the debts were not going to be defended by the official community to the last penny of interest.

4. Towards Efficient Debt Reduction

The voluntary approach, at least as now conceived, is unlikely to succeed in its central purpose: to restore the creditworthiness of the debtor countries in order that they may achieve productive efficiency. Debt reduction should be comprehensive to achieve this goal, but we have seen that several important barriers block a comprehensive settlement on a voluntary basis: the inevitable tendency of holdouts to wait for others to grant relief; the problem of precedents; the expectation of official bailouts; and the distorted incentives of the largest banks.

These problems can be overcome, but only with a resolute set of actions by the official creditor community. The key point that the official community should recognize is that a real debt settlement requires the concerted participation of the banks. To the extent that there remains a "menu of options" for the banks, this menu should only include alternative ways of accomplishing debt reduction. In other words, banks should not have the luxury of opting out of the debt reduction process entirely, for that frustrates the whole process.

The simplest way to achieve a comprehensive reduction of debt is through a reduction of interest rates to sub-market levels on the existing debt. This mechanism is nearly ideal: it is administratively straightforward (the contracts merely have to be rewritten to include interest rates of, say, a fixed 4 percent, rather than LIBOR plus 13/16); it is comprehensive; it is equitable in its impact across banks; it avoids the adverse consequences of debt-equity swaps; it is a standard mechanism for debt workouts in the domestic context; and it may even obviate the need for large, immediate writedowns of capital under U.S. banking regulations.[40] Furthermore, it is easy to combine interest rate relief with credit enhancement, since the reduced interest rates can be guaranteed by the official creditors, e.g. the World Bank, as part of the restructuring process.

Achieving a comprehensive debt reduction for a particular debtor country will require several steps on the part of the official creditor community (especially the IMF and World Bank):

1. An explicit recognition by the IMF and World Bank that the debt burden of the country should be permanently reduced (conditional on the commitment of the debtor country to

[40]Under FASB 15, a debt restructuring which preserves principal, but which reduces interest rates, does not in general require a capital writedown.

pursue appropriate macroeconomic policies);

2. An official policy that the banks should share <u>equally</u> in the debt reduction. A "menu of options" may still be used in recognition of regulatory differences facing different banks, but in economic terms, all banks should participate equally in the debt reduction mechanism.[41]

3. An official policy against debt-equity swaps as a significant component in debt reduction, except for the handling of private sector debt or the case of privatisation of a public-sector firm.

4. The design of official lending programs (e.g. standby programs and structural adjustment lending) based on debt-servicing targets that take into account the necessary debt reduction.[42]

5. An official policy that IMF and World Bank programs can go forward despite arrears to the commercial banks in circumstances in which the IMF determines that the debt should be reduced, but in which the banks have not yet agreed to a comprehensive debt reduction mechanism.

6. Regulatory support for debt reduction, with regulators requiring writedowns of debt to market values for those countries for which debt reduction packages are not concluded. At the same time, a stretching out of writedowns in the cases that comprehensive debt agreements are reached.

7. The use of official money to "enhance" the interest stream of debt for cases in which the countries and the commercial banks have agreed to a comprehensive debt reduction scheme. The official institutions can provide partial or complete interest payment guarantees, depending on the precise economic circumstances of the debtor country,

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[41] As an example, some banks might prefer to take debt reduction by a cut in principal, while others would prefer to maintain principal while accepting a sub-market interest rate level. These differences should be accomodated in a menu of options, but all banks should be required to choose among the menu. New money, or longer maturities and grace periods, definitely <u>should not</u> be equated to debt reduction in the menu.

[42] In other words, if a country has a huge overhang of debt, the IMF and World Bank programs for the country should be designed on the assumption that the debt will eventually be reduced in negotiations between the debtor and the banks.

and the nature of the debt reduction agreed to with the commercial banks.

8. Strict conditionality on official lending for all countries negotiating debt reduction programs, and for all countries seeking programs in the face of commercial bank arrears.

9. A policy that sustained interest arrearages on payments <u>after</u> debt reduction has taken place should trigger cross-default provisions with other IMF and World Bank lending. This is especially important in cases in which there are official guarantees of the interest payments that have been missed.

10. An official policy of support for debt reduction through the mechanism of <u>sub-market interest rates</u>, as the simplest, fairest, and administratively easiest form of comprehensive debt reduction.

To understand the import of these principles, it is useful to focus on a concrete case. For that, I will choose the pending negotiations with Ecuador.[43]

4.1. Targetting debt reduction: the case of Ecuador

Ecuador offers an important case for debt reduction, and an important illustration of the crucial choices facing the official creditor community in guiding the process of debt reduction. Since 1981, per capita income in Ecuador has declined by more than 8 percent. Urban unemployment has reached 13 percent, and the real minimum wage has fallen by 46.4 percent since 1980. Ecuador's terms of trade has deteriorated by 33 percent since 1980. Since early 1987, when Ecuador was hit simultaneously with

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[43] The author participated in a fact-finding and advisory mission to Ecuador on behalf of the United Nations Development Program in October 1988.

a collapse of international oil prices and a severe earthquake, the government has been in suspension of interest payments on commercial bank debt. A "new money" package was negotiated between the government and the banks in 1987, but the agreement lapsed when the banks failed to come up with the full amount of lending to which they had committed, and when it became clear to the Ecuadorian government that even were the money available, the remaining interest servicing due under the agreement was far beyond the government's capacity.

A new government came into power in August 1988, inheriting the debt suspension, a macroeconomic mess (negative net reserves, inflation rates of nearly 100 percent, and stagnant growth in the non-oil economy), and an extremely difficult political situation, with deep polarization and unrest. The government immediately implemented strong stabilization measures designed to reduce the budget deficit and to unify the exchange rate at a realistic rate. It also charted out a path of longer-term reforms. At the same time, the government announced its intention to pursue negotiations with the creditor banks in search of a fundamental solution to the external debt problem, rather than another short-term patch-up. Importantly, the new government has expressed its eagerness to pursue lending programs with the IMF and the World Bank, and to submit to the conditionality of those institutions.

With a debt-GNP ratio of about 140 percent, Ecuador presents a clear case for debt reduction. The secondary market value of the debt stands at 13 cents on the dollar (as of January 5, 1989). Both measures suggest that the debt burden will have to be reduced significantly and permanently as a basis for economic recovery. Of course, a detailed estimate of reasonable capacity to pay, with due attention to social, political, and budgetary considerations, would be needed to fix an appropriate target for debt reduction.

The IMF and World Bank will face a decision vis-a-vis Ecuador in the near future. Ecuador is requesting a standby agreement with the IMF, and as usual, the IMF will recommend a program of fiscal austerity for the country. The nature of the program, however, will depend <u>fundamentally</u> on the Fund's treatment of the Ecuadorean debt. If the Fund treats the debt in a normal bureaucratic manner as requiring full servicing at market interest rates, then the Fund will determine that the Government of Ecuador has a gaping budget deficit of more than 8 percent of GNP. It will recommend a program of crushing austerity, in order that the government generate the resources to service the interest. If the government actually tried to follow such a program, it would surely plunge the country into serious political unrest.

If instead the Fund acknowledges that the interest cannot seriously be considered as payable, it will determine that the budget is close to balance, once allowance is made for substantial debt reduction. Most of the definition of the budget deficit, and the need for austerity, will depend on one's accounting of the 8.5 percent of GNP that is due in commercial bank interest servicing each year.

The Fund might believe that it can duck this determination altogether, by deciding that Ecuador must arrange adequate financing or debt reduction with the banks <u>before</u> an IMF program can be established. But in this case, the Fund is essentially condemning Ecuador to respect its debt payments or choose the path of ostracism from the official financial community by failing to conclude an IMF program. If the banks know that Ecuador must choose between signing a bank agreement or walking away from a Fund program, the banks will certainly be unwilling to explore any serious options regarding debt reduction.

In sum, the IMF can push the process of debt reduction only by acknowledging (either implicitly or explicitly) the need for debt reduction, and then giving Ecuador the time to negotiate a program of debt reduction. To do this, the IMF must extend a program to Ecuador despite the presence of large and growing bank arrears, with the understanding that the arrears will be settled only when a long-term arrangement is reached between Ecuador and the banks.

A final settlement on Ecuador's bank debt is not hard to envision. The interest rate should be brought down to sub-market rates, reflecting the secondary market price of Ecuador's debt and other indicators of capacity to pay. These sub-market rates should then be collateralized by a combination of official guarantees (e.g. from the World Bank), and perhaps by the pledge of future receipts on oil export earnings.[44] The rate of interest could itself be indexed to the price of oil, so that an increase in oil prices leads to a rise in the rate of interest on the loan. Finally, a "kicker" might be attached to the new loan, such that interest payments are increased in step with increases in GNP growth above a certain rate.

4.2. The role of conditionality with debt reduction

Debt reduction should only be granted to countries pursuing internationally supervised programs of stabilization and structural adjustment. Especially in cases in which official creditors are providing guarantees on interest payments, there is a legitimate role for conditionality in protecting the use of official financing. It is sometimes suggested that debt reduction would take the pressure off of conditionality, i.e. that a "tight leash" on debt is necessary to make countries undertake programs of economic reform. Both theory (e.g. Sachs, 1989b) and experience suggest otherwise. Debt reduction can enhance the effectiveness of conditionality by making it more likely that a good government can maintain power, and by offering governments a more attractive incentive to pursue a reform program.

It would indeed be prudent for the official community to

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[44] Ecuador already has extensive experience with collateralizing interest payments with future oil earnings, in the form of a special "oil facility" with the commercial banks that was operative in recent years.

press for debt reduction only after a government has a track record of successful adjustment efforts (in the meantime, arrears on debt repayments might be a necessary evil, in lieu of an adequate financing package). What is important is not the actual timing of debt reduction, but the ex ante commitment by the official community to support debt reduction for any government in fact pursues an effective adjustment program under the supervision of the international financial institutions, in circumstances in which the debt is demonstrably beyond the political and economic capacity of the country to pay in full.

4.3. Legal and regulatory aspects of concerted debt reduction

Concerted debt reduction requires that a high proportion of banks agree to a restructuring of debt at sub-market interest rates. Since the sub-market rates will enjoy credit enhancement with official funds, the package of debt reduction cum credit enhancement should be attractive to the vast majority of banks, as most of these banks are already divesting their portfolios on the secondary market at substantial discounts. Furthermore, as a practical matter, the difficulty will lie in gaining the assent of the biggest banks in the steering committee, rather than the smaller banks.[45]

[45]Interestingly, this is nearly the opposite of the case of concerted lending, in which the big banks participate while the smaller banks attempt to avoid participation. In the case of debt reduction, the smaller banks will on the whole be delighted to be done with the problem, and have demonstrated a willingness

In my view, the difficulties of achieving a concerted settlement are vastly overstated. The big problems have already been mentioned: given current regulatory and official lending policies, the big banks have no particular reason to concede to relief now. Once the official policies change, then the incentives facing the large banks will change as well. The main changes needed are fourfold: (1) an end to official bailouts of interest servicing; (2) a tolerance of interest arrears in the course of debt negotiations; (3) a regulatory environment in which book profits look better if the banks agree to a concerted debt reduction; and (4) official money available for credit enhancement.

Complete unanimity among the banks would <u>not</u> generally be required to achieve a concerted restructuring. The debt contracts of each country allow for debt restructurings with various qualified majorities of creditor banks, in some cases two-thirds of the banks, in other cases three-fourths, and in some, simple majorities.

It is important to keep in mind, as well, that even if the regulatory changes fail to break the logjam, there are some "big guns" in the official policy arsenal that can do the job. There is in fact a "neutron bomb" of debt contracts that would destroy the old contracts, and yet leave the debtors standing. It has been described recently as follows:

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to accept losses.

There is a provision under the IMF articles (Article VIII), which would provide for an arrangement of payments and exchange restrictions approved by it to supersede all previous arrangements, and which could not be challenged in the courts of any of its members. Thus, if some banks refuse to participate in an IMF approved arrangement, and if the debtor countries discriminate against those banks and met their obligations only after meeting those of the banks which participate in the arrangement, the latter are given effectively a senior status, which the former cannot challenge.[46]

Within the U.S., similar policy options exist, as shown by the legal history of Allied Bank vs. Costa Rica, in which a U.S. bank attempted to sue Costa Rica for nonpayments on a sovereign debt contract. In the first decision of the court (566 F.Suppl440), the court ruled in favor of Costa Rica, and refused to enforce the contract on behalf of the plaintiffs, on the grounds of a doctrine known as "state action". The court essentially held that as long as Costa Rica's actions in not paying were fully supported by the U.S. Government, then the courts would not enforce a judgement against Costa Rica in support of U.S. foreign policy interests. In the event, the court later reversed itself (Allied vs. Costa Rica, 567 F.2d 516) when the U.S. Government made clear that in fact it would like Costa Rica to pay the debt.[47] But the point here is not the

[46]See Arjun K. Sengupta, "The LDC Debt Problem: Some Reflections on the Proposed Solutions", December 12, 1988, speech delivered at the Japanese Economic Planning Agency, p. 9.

[47]The ironies here are wonderful, since the court originally took it as a matter of course that the U.S. Government would want Costa Rica to enjoy relief on the debt. Judiciary, meet the Baker Plan!

final resolution of the case, but the fact that the enforceability of contracts by the banks appears to depend importantly on the U.S. policy position on the debt contracts. This is leverage that can be held in reserve.

5. Conclusions

This paper has stressed that effective debt management should mimic two of the essential characteristics of bankruptcy: the debt burden should be reduced, and all creditors should participate in a concerted settlement. The paper suggests, at some length, why the "new money" approach has broken down, and stresses that even while it may work (occassionally) for the largest countries, it simply does not function at all for the smaller debtors. The paper also casts doubt on the efficacy of the "voluntary" approach to debt reduction, in which individual creditors are permitted to choose whether or not to participate in a debt reduction scheme. Such voluntary arrangements make as much sense as voluntary bankruptcy, that is, not very much. There are simply too many obstacles (e.g. inherent externalities, distorted incentives of the largest banks, etc.) to give much hope to a fully decentralized market approach to debt reduction.

The most efficient and straightforward form of debt reduction would be a rescheduling of existing debt at <u>sub-market</u> interest rates. The official creditors could play an important role in the process by providing official guarantees on the interest rates after they have been reduced. There are many important steps that could be taken by the policy community to bring about a settlement on this basis, including regulatory changes, and changes in the lending policies of the international financial institutions. The regulators should be more aggressive in requiring banks to set aside allocated reserves on their LDC debt, so that distortions in book valuations of LDC debt do not create disincentives to debt reduction. Also, the international financial institutions should recognize that interest arrearages can be a normal part, and perhaps are an inevitable part, of a process leading towards debt reduction.

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